

This letter discusses sales of prescription drugs by servicemen. See 86 Ill. Adm. Code Part 140. (This is a GIL.)

August 2, 2013

Dear Xxxxx:

This letter is in response to your letter dated May 20, 2013, in which you request information. The Department issues two types of letter rulings. Private Letter Rulings ("PLRs") are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. Persons seeking PLRs must comply with the procedures for PLRs found in the Department's regulations at 2 Ill. Adm. Code 1200.110. The purpose of a General Information Letter ("GIL") is to direct taxpayers to Department regulations or other sources of information regarding the topic about which they have inquired. A GIL is not a statement of Department policy and is not binding on the Department. See 2 Ill. Adm. Code 1200.120. You may access our website at [www.tax.illinois.gov](http://www.tax.illinois.gov) to review regulations, letter rulings and other types of information relevant to your inquiry.

The nature of your inquiry and the information you have provided require that we respond with a GIL. In your letter you have stated and made inquiry as follows:

ABC operates a nationwide Medicare Prescription Drug Plan under contract with the COMPANY. ABC would like to request a General Information Letter (GIL) on the applicability of the Illinois Retailers' Occupation Tax Act on Medicare Part D Plans when federal law specifically prohibits States from imposing premium taxes, fees or other similar assessments for any payment COMPANY makes on behalf of the Part D plan or enrollees.

ABC is aware that pharmacists in the State of Illinois are required to collect sales tax on prescription drugs. As stated by the Department of Revenue, in general, sales made to Medicare and Medicaid are exempt from tax as sales to a government body but "PDPs operate as private insurance companies under contract with the government. They, not the government, are responsible for purchasing drugs for their beneficiaries. The beneficiaries usually pay a co-pay. Since sales are made to the PDPs and not directly to the government, the drug sales do not qualify for the government tax exemption." See 12-0015-GIL and 10-0012-GIL.

Payments received by Medicare Part D plans from COMPANY for prescription drugs do not relate to its net income or profit and, as stated previously, cannot be assessed a tax, fee or other similar assessment. Therefore, federal law, specifically 42 CFR § 423.440, would prohibit the State of Illinois from collecting tax on prescription drugs.

Based on the foregoing, ABC would like the State to revisit its position on this matter by providing a GIL, which takes into consideration 42 CFR § 423.440.

For your convenience, I have provided the relevant excerpt from the federal regulations:

42 CFR § 423.440. Prohibition of State imposition of premium taxes; relation to State laws.

- (a) Federal preemption of State law. The standards established under this part supersede any State law or regulation (other than State licensing laws or State laws relating to plan solvency) for Part D plans offered by Part D plan sponsors.
- (b) State premium taxes prohibited.
  - (1) Basic rule. No premium tax, fee, or other similar assessment may be imposed by any State, the District of Columbia, The Commonwealth of Puerto Rico, the Virgin Islands, Guam, and American Samoa, the Mariana Islands or any of their political subdivisions or other governmental authorities for any payment COMPANY makes on behalf of Part D plan or enrollees under this part (including the direct subsidy, reinsurance payments, and risk corridor payments); or for any payment made to Part D plans by a beneficiary or by a third party on behalf of a beneficiary.
  - (2) Construction. Nothing in this section may be construed to exempt any Part D plan sponsor from taxes, fees, or other monetary assessments related to the net income or profit that accrues to, or is realized by, the organization from business conducted under this part, if that tax, fee, or payment is applicable to a broad range of business activity.

Please do not hesitate to contact me if you have any questions or concerns.

#### **DEPARTMENT'S RESPONSE:**

The Illinois Retailers' Occupation Tax Act imposes a tax upon persons engaged in this State in the business of selling tangible personal property to purchasers for use or consumption. See 86 Ill. Adm. Code 130.101. The tax is measured by the seller's gross receipts from retail sales made in the course of such business. In Illinois, Use Tax is imposed on the privilege of using, in this State, any kind of tangible personal property that is purchased anywhere at retail from a retailer. See 35 ILCS 105/3; 86 Ill. Adm. Code 150.101. These taxes comprise what is commonly known as "sales" tax in Illinois. If the purchases occur in Illinois, the purchasers must pay the Use Tax to the retailer at the time of purchase. The retailers are then allowed to retain the amount of Use Tax paid to reimburse themselves for their Retailers' Occupation Tax liability incurred on those sales. If the retailer does not collect the Use Tax from the purchaser for remittance to the Department, the purchaser is responsible for remitting the Use Tax directly to the Department. See 86 Ill. Adm. Code 150.130.

Illinois Retailers' Occupation and Use Taxes do not apply to sales of service that do not involve the transfer of tangible personal property to customers. However, if tangible personal property is transferred incident to sales of service, this will result in either Service Occupation Tax liability or Use Tax liability for the servicemen depending upon his activities. For your general information see of 86 Ill. Adm. Code 140.101 through 140.109 regarding sales of service and Service Occupation Tax.

The Department's regulation at 86 Ill. Adm. Code Section 130.311 governs Drugs, Medicines, Medical Appliances and Grooming and Hygiene Products and can be found on the Department's website. Those products that qualify as drugs, medicines and medical appliances are taxed at a lower State rate of 1% plus any applicable local taxes. Those items that do not qualify for the low rate of tax are taxed at the general merchandise rate of 6.25% plus applicable local taxes.

Pharmacists who sell prescription drugs to customers are considered to be servicemen under the Service Occupation Tax Act. Servicemen may calculate their tax base in one of four ways: (1) separately stated selling price; (2) 50% of the entire bill; (3) Service Occupation Tax on the cost price if they are registered de minimis servicemen; or, (4) Use Tax on the cost price if the servicemen are de minimis and are not otherwise required to be registered under Section 2a of the Retailers' Occupation Tax Act.

Using the first method, servicemen may separately state the selling price of each item transferred as a result of sales of service. The tax is based on the separately stated selling price of the tangible personal property transferred. If servicemen do not wish to separately state the selling price of the tangible personal property transferred, those servicemen must use the second method where they will use 50% of the entire bill to their service customers as the tax base. Both of the above methods provide that in no event may the tax base be less than the cost price of the tangible personal property transferred. Under these methods, servicemen may provide their suppliers with Certificates of Resale when purchasing the tangible personal property to be transferred as a part of the sales of service. Upon selling their product, they are required to collect the corresponding Service Use Tax from their customers. See 86 Ill. Adm. Code 140.106.

The third way servicemen may account for their tax liability only applies to de minimis servicemen who have either chosen to be registered or are required to be registered because they incur Retailers' Occupation Tax liability with respect to a portion of their business. Servicemen may qualify as de minimis if they determine that their annual aggregate cost price of tangible personal property transferred incident to sales of service is less than 35% of their annual gross receipts from service transactions (75% in the case of pharmacists and persons engaged in graphic arts production). See 86 Ill. Adm. Code 140.101(f). This class of registered de minimis servicemen are authorized to pay Service Occupation Tax (which includes local taxes) based upon the cost price of tangible personal property transferred incident to sales of service. Servicemen that incur Service Occupation Tax collect the Service Use Tax from their customers. They remit the tax to the Department by filing returns and do not pay tax to suppliers. They provide suppliers with Certificates of Resale for the property transferred to service customers. See 86 Ill. Adm. Code 140.108.

The final method of determining tax liability may be used by de minimis servicemen not otherwise required to be registered under Section 2a of the Retailers' Occupation Tax Act. Servicemen may qualify as de minimis if they determine that their annual aggregate cost price of tangible personal property transferred incident to sales of service is less than 35% of their annual gross receipts from service transactions (75% in the case of pharmacists and persons engaged in graphic arts production). Such de minimis servicemen may pay Use Tax to their suppliers or may self assess and remit Use Tax to the Department when making purchases from unregistered out-of-State suppliers. Those servicemen are not authorized to collect "tax" from their service customers because they, not their customers, incur the tax liability. Those servicemen are also not liable for Service Occupation Tax. It should be noted that servicemen do not have the option of determining whether they are de minimis using a transaction-by-transaction basis. See 86 Ill. Adm. Code 140.109.

It is my understanding that most pharmacists in this State use the third method to calculate their liability. As noted above, the third method is based upon the serviceman's cost price for the tangible personal property transferred. For example, if the serviceman paid \$20 for the drugs, he will owe Service Occupation Tax based upon his \$20 cost price even when he sells the drugs with a markup. It is important to stress that the third method is applicable only to de minimis servicemen who have either chosen to be registered or are required to be registered because they incur Retailers' Occupation Tax liability with respect to a portion of their business. Customers purchasing prescriptions from these servicemen incur a corresponding Service Use Tax liability. The provisions of the Service Use Tax Act require the pharmacists to collect this tax from their customers. See 35 ILCS 110/3-40. Servicemen can collect this tax in one of two ways: (1) they can separately state the tax from the price of the service (and must do so if requested by the customer); or (2) they can include the tax in the total price of the service. How taxes are collected by such servicemen is generally a business decision of the servicemen and is not within the jurisdiction of the Department. Traditionally, many pharmacists in this State have included tax in the total price of the service.

In general, sales made to Medicare and Medicaid are exempt from tax as sales to a government body so long as the exemption is properly documented through provision of an active exemption identification number "(E" number). See 86 Ill. Adm. Code 130.2080(a). While no tax may be due on payments made directly to vendors by Medicare or Medicaid, tax is due upon any portion of the bill paid by individuals or private insurance companies not covered by Medicare and Medicaid.

This means when Medicare directly pays 80% of the medical bill and the remaining 20% is billed to the patient or his insurance company, assuming proper documentation of the exemption, the 80% is tax exempt as a governmental payment while the 20% is taxable. In the case of an unregistered de minimis serviceman, (see the final method above), he or she may take a pass through of the exemption when selling to Medicare or Medicaid. Such servicemen will still owe Use Tax on the portion of the cost billed to the patient. See 86 Ill. Adm. Code 140.108(a)(2)(A) and 86 Ill. Adm. Code 140.108(a)(2)(B).

The Medicare Part D Prescription Plan is organized differently. The government provides funds on a per capita basis to the Prescription Drug Providers (“PDPs”). The PDPs operate as private insurance companies under contract with the government. They, not the government, are responsible for purchasing drugs for their beneficiaries. The beneficiaries usually pay a co-pay. Since sales are made to the PDPs and not directly to the government, the drug sales do not qualify for the government tax exemption. Therefore sales of drugs are not exempt from sales tax under the Medicare D Plan. Please note that according to the U.S. Department of Health and Human Services, sales tax cannot be added to a beneficiary’s co-payment under the Plan. As a result, sales tax is due on drugs sold under the Medicare Part D Plan, but it may not be charged to the beneficiary. The same applies to the State of Illinois Rx Program.

As pointed out above, generally most pharmacists calculate their tax liability under one of the sales tax Acts, e.g., the Service Occupation Tax, which is not a premium tax, fee, or other similar assessment. As such, the collection of tax under one of the four above-referenced sales tax Acts is not prohibited by 42 CFR § 423.440 which is specific to a “premium tax, fee, or other similar assessment.”

I hope this information is helpful. If you require additional information, please visit our website at [www.tax.illinois.gov](http://www.tax.illinois.gov) or contact the Department’s Taxpayer Information Division at (217) 782-3336.

Very truly yours,

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Associate Counsel

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